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THE ROLE OF VENTURE CAPITAL IN FINANCING HORTICULTURAL EXPORTS

by

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by

Douglas L. Leavens and Gregory B. Boyd[1]

Financing for business start-up or expansion can come from sources internal or external to the business. In the case of horticultural projects in Sub-Saharan Africa, most are internally financed by utilizing resources from other successful operations. In practice, it is difficult to identify and access the sources of finance appropriate to the enterprise's business activities for those projects which require external financing. In the emerging market environments of Sub-Saharan Africa, developing a balanced financial structure is a major challenge.

In this paper, we will start with a description of what venture capital is and conditions necessary to attract venture capital to horticultural investments, followed by some recent examples. This leads to the preparation of a project feasibility study and financing plan as the basis for marketing the project to venture capital investors. Although venture capital is new to Africa, there are a growing number of venture capital investment management companies which may be helpful. A directory is provided to help locate them. Last, but most importantly, we discuss the essential support role of governments and development agencies in enabling venture capital to mobilize and invest new capital.

I. What is Venture Capital?

There is a hierarchy of financing mechanisms starting with short term working capital and trade financing, through long term secured finance for equipment purchases, permanent working capital and expansion, to the quasi-equity and equity sources which accept the fundamental business risks in exchange for a share in the business profits. The venture capital investor comes in at the bottom of the hierarchy, sharing in the business risk, and expecting to share also in the future earnings of the company.

Venture capital attempts to cater to the financial and managerial needs of new operations through arrangements that involve essentially the investor's equity participation in a firm, through the direct purchase of stock or through warrants, options, or convertible securities; a long-term investment horizon (five to 10 years); and the investor's active involvement in the invested company. Typically, venture capital finances start-ups and the expansion of existing operations

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in terms of advancing into new stages in the production and/or distribution process. (Sagari & Guidotti, January 1991).

Why would an entrepreneur want to enter into a partnership with a venture capital investor in order to finance business growth rather than borrow from the bank? Finding long term financing of any kind is difficult in Africa. There are many reasons why long term debt financing is hard to find in Africa, starting with economic uncertainty. When the future is uncertain, investors want to keep their funds in short term liquid investments. Under such conditions, the concept of possibly earning higher rates of return for taking greater risk over a longer period of time is just not attractive. In Africa, government instability, high inflation, and poor enabling environments for private sector development all contribute to uncertainty.

Even when lending institutions have access to adequate funding, it is difficult for small and medium size companies to qualify for a loan. Banks in Africa lend against collateral to protect the bank if the loan is not repaid and not against the expected future earnings of the project, called cash flow lending. But, most companies in a start-up or expansion stage do not have the collateral banks require. Even if the funding and collateral can be arranged, the high interest charged to cover inflation, or the foreign exchange risk for borrowing in foreign currencies, can make the cost of debt financing prohibitive.

Venture capital overcomes these problems by taking claim to a share in the enterprise's overall growth, not restricted to an agreed interest rate, and as a full partner in the business shares in all the business risk. Debt financing commits the borrower to a current and on-going cash flow drain in the form of interest and principal payments, while equity does not. For a enterprise which needs all its cash to run the business during the early start-up years, equity provides a financial resource without using cash flow.

Because venture capital can demand a proportional share of entrepreneurial growth, it can also accept more risk than debt. In accepting greater risk, venture capital also requires the flexibility to decide when to take its profits or to cut losses and exit an investment. An enabling environment supporting a range of financial institutions and instruments is a critical factor in promoting private sector growth and reducing business uncertainty. Such a positive economic environment attracts venture capital.

Harvey & Company, Inc. manages the African Venture Capital Project (AVCP), a five-year contract for the U.S. Agency for International Development. The goal of the AVCP is to introduce venture capital to emerging market economies in Sub-Sahara Africa as an innovative mechanism to mobilize capital to finance the growth of small and medium sized enterprises.

During the last four years through the AVCP, we have: set-up three operating and capitalized venture capital companies and provided technical assistance and funding support for two other venture capital funds in formation and for the creation of a leasing company to fund privatization of state owned assets; and conducted feasibility studies and provided technical assistance to potential sponsoring institutions for the start-up of 12 additional venture capital companies, of which five are operational. Our work has taken us into some 20 African countries. From that experience, we have learned a great deal about the opportunities for venture capital financing, as well as the limitations.

No one professes to have found the best venture capital model; however, a variety of initiatives are being tried with growing success. What we do know is that a number of conditions must exist to make the mobilization of capital for high risk local entrepreneurial investment likely to happen. We identify five such conditions.

- The enabling environment of government regulation, tax law, private ownership, corporate law, trade tariffs, foreign exchange controls, and policy advocacy for private entrepreneurship must be firmly in place. Venture investing looks to a long term payback which, in turn, requires a reasonably stable and supportive basis for planning.

- Knowledgeable, experienced fund managers must be recruited. Typically, these people will possess practical business experience and will have developed extensive financial and technical skills. They must be objective in making investment decisions and be able to act independently from external influences. Ultimately, they must be at risk personally in exercising their business judgement. If successful, they must be rewarded appropriately. If the fund fails, they will also forego their reward.

- The ability to develop a list of interesting and appropriate investee candidates, known as a deal flow, must be evident. We believe that start-up new ventures are not generally appropriate for formal sector venture investing during the early stages of a venture capital fund in the developing world of Africa. The deal flow is more likely to be from existing, proven entrepreneurs with established businesses ready to expand significantly or to take on an important new product or partner.

  In addition, the venture fund management must be able to identify specific areas in the investee company's operations for which they have the expertise to add value and assist materially in the investee's rapid growth. This may be in improving the overall quality of management, accounting procedures, planning and control, establishing inventory procedures, technical operations or creating markets.

- The venture capital fund managers will have to either raise investment funds locally or attract foreign sources. Pension funds, banks, insurance companies and private individuals are usual local sources. Also, Development Finance Institutions (DFIs) may be willing to take an equity share. Since a key AVCP goal is to strengthen local financial capacity while building replicable institutions, we believe significant local involvement in the fund is essential.

- Finally, disinvestment strategies, or exit options, must be identified and negotiated up front, when the investment is made. The usual exit route for the venture fund is an initial public offering on a stock exchange. This route is not possible at present in most African countries. Other strategies, such as management buy-outs, possibly through redeemable/ repayable investments known as "earn-outs", bank refinancing, corporate acquisitions or private placements must be thought through.

II. Venture Capital and Horticulture

Is venture capital an appropriate financing mechanism for horticulture? A rule of thumb is that venture capital investors look at 100 projects to find 10 that are attractive. This reality applies to all type of projects, so it should not come as a surprise that many horticultural investments can not provide the high growth potential and long term returns which attract venture capital investors. The key factors for the venture capitalist in making an investment are: first, the proven experience and capabilities the entrepreneur they are going to invest with; second, the soundness of the project; and third, the ability of the investor to develop a close working relationship with the entrepreneur and other owners of the company.

The venture capital investor is looking for that rare opportunity to join as a full partner with an experienced entrepreneur to either start-up or expand a business with significant growth potential. But it is the entrepreneur who will be in charge of running the business and responsible for making it work. While some people are naturally more entrepreneurial than others, the entrepreneur requires training and experience. As a matter of state policy in many African countries indigenous business managers have been discouraged from developing entrepreneurship skills. This policy is changing, opening new opportunities. And, in spite of the hard times and official disincentives to private business, there are good entrepreneurs to be found.

Second, the business logic of the investment must be sound offering a compelling competitive advantage in the market place. Growth and expansion business with a competitive advantage may offer the potential for high returns, but they also are risky and may fail. Venture capital investors expect to write off some of their investments, while other investments may only generate a nominal rate of return from dividends. Therefore, in order to mobilize capital into risky venture capital investments, some investments must hit the jackpot and boost the investor's return on investment (ROI) when the appreciated shares in the company are sold. Over time, venture capital investors may look for a 30% to 50% real rate of return per year to attract funds. Finding exit strategies that will produce these rates of return in the under developed financial markets of Africa is a challenge.

Finally, the chemistry between the entrepreneur and the venture capital investor has to work. They must trust each other and really be able to work together, because more than money will be required to make the project really take off. Why? Because most business plans change significantly from the time they are launched through the full life cycle and only investors who can work together can over come the inevitable obstacles.

As with any potential investment, there must be a strong comparative advantage for the business to attract venture capital. There are some business conditions frequently encountered in horticulture which can signal that venture capital is not an appropriate financing mechanism. Some crops have too low a market value or take too long to mature to generate the required increase in shareholder value. In other cases the market may be flooded with the same, or comparable products driving down returns. Or the lack of adequate transportation may block the product's coming to market. Other risks include weather, product liability, quality control, technology, and always - marketing. So with all this down side risk, what are some of the positive aspects of horticulture which can get a venture capital investor to sit up and take notice? Basically, they are the same positive factors as for any other industry:

- a specialized product with an identified market niche;
- a high value crop or a process to add value which can command high returns;
- proven technology and the management skills to operate it, but not necessarily hi-tech;
- a short pay back period generating cash flow to support the business;
- an appropriate financial structure with the owners of the company at risk;
- competitive advantage from an innovative distribution system or marketing strategy.

III. Examples of Horticultural Projects Financed

Across Africa, venture capital has been attracted to horticultural projects such as cut flowers, pineapple cultivation and processing, manufacturing of tropical fruit juices, prawn farming, irrigation farming and production of products used in pharmaceutical and chemical processes. As of December 31, 1993, The Africa Project Development Facility (APDF) of the International Finance Corporation (IFC) had completed 133 projects in the farming and agro-industry sectors. In 1993, 13 of the APDF projects supported horticulture and related investments for which the equivalent of $9.2 million was raised. Of this total funding, $194,000, or 2%, was in the form of equity.

The African Enterprise Fund, which is an arm of the IFC, has financed a limited number of horticultural projects. Their preferred instrument is a venture loan with an equity kicker based on the level of sales, rather than profits. The financed projects are for expansion, rather than start-up, and are all producing for export to Europe.

The Commonwealth Development Corporation (CDC), a long time investor in African agribusiness, has also made investments in horticultural projects, including cut flowers. In recent years, CDC in collaboration with USAID, has invested in two venture capital companies in Africa which have in turn evaluated, and are considering investments in, horticultural projects.

A review of some of these projects may provide some insights as to the venture capitalist's perspective when evaluating a horticultural investment.

Pineapples - an expansion stage project is approved for financing. The project will improve the product quality, quantity and export marketing program. The investment attraction is the quality of management, the cash flow potential and the ability to negotiate an exit strategy with the present owners.

Cut flowers - several projects have been evaluated in various countries with different conclusions. In this highly competitive business, it is recognized that the entrepreneurs needed to have energy, vision and strong technical skills to stay on top of market demand. A well developed distribution and buyer network are also critical. In one instance the entrepreneurs did not meet the investor's criteria. In another, the equity investor had to take over the management to prevent bankruptcy. And in a third, a decision was taken to provide debt finance with a possible equity investment to follow. Economy of scale can be an important factor in profitability, together with the ability to establish a market differentiation. For example, there is a rose farm in Mexico which combines economies of scale with name brand recognition for its roses to achieve a comparative advantage resulting high profitability. Such a combination attracts venture capital.

Frequently, cut flower operations are financed internally by a group which has already been successful in another line of business. This was the case in Tanzania when two successful business men started a new cut flower farm in Arusha. Following the success in cut flowers, they started looking for a new investment and realized there is a large demand for pumps to supply irrigation, and many other industrial applications. That realization led to a joint venture with a Dutch manufacturer of pumps, and a venture capital investment.

Prawn farming is another industry with rapid global expansion and high competition. Since the industry requires extensive technical experience, it is not for start-up entrepreneurs. However, given the right promoters who have the technical experience and know how to adapt it to local conditions, prawn farming can be profitable and attract venture capital. We know of one project which has been turned down because of the high start-up risk and another which has a world class team and is likely to go forward.

Irrigation farming for paddy rice, oranges, pineapple and papaya is an attractive investment targeted at a second stage expansion for mostly regional markets. The lack of adequate regional supply due to poor distribution prevents surplus supplies from other regions entering the target market. Given the high demand, the comparative advantage, and thus the profitability of this project, rests on how long it will take for government authorities to upgrade the infrastructure.

Canning of fresh fruit juices is a potentially attractive industry under review. There are a number of issues to over come before a decision is made. The processing plant must be close to the source of supply, electrical power and transportation facilities. At present, the growers are removed from the national electrical distribution grid and the roads are too poor to permit the plant to be located at a distance. A solution is being sought.

Specialty crops which have a small, but high value market niche and a tight buyer relationship can be attractive. We are thinking of several that produce natural pesticides, eco-friendly biofertilizer or even tropical freeze dried fruits and vegetables for export.

There are infrastructure requirements which can either block a project or offer a new investment opportunity, depending on your point of view. These inputs can include cold storage facilities, air freight capacity, packaging facilities, transportation and distribution, technical services, and so forth.

IV. Preparing a Project to Attract Financing

There are a number of excellent resources to which the entrepreneur can refer in preparing a project for financing. We have utilized Pratt's *Guide to Venture Capital Sources* in preparing the following road map for the entrepreneur.

Do I Have a Viable Idea?

Imagine that you are sitting in a venture capitalist's chair and you have just analyzed what you did with the few hundred business proposals you examined last year. Your analysis shows that you handled the various proposals in these ways.

1. Rejected 60% of them after a 20-to-30 minute scanning.

2. Reviewed another quarter for a few hours and then discarded them.

3. Investigated about 15%, in depth, and then turned two-thirds of them down because of one or more serious flaws in the management team or the business plan -- flaws that could not be remedied or at least not remedied in less than one year.

4. Decided to invest in 5% of them but could only negotiate acceptable terms with the entrepreneurs and other existing stockholders with 3%.

The 15% that you investigated in some depth were presented by strong, well-balanced management teams who had been able to show you relevant accomplishments in marketing, finance, and operations and had developed (perhaps with some prodding by you) a comprehensive business plan.

Armed with this insight into the investor's perspective, if you are really interested in going into business for yourself, you should start to develop a comprehensive business plan. Before developing your business plan, ask yourself those simple but vital questions that the venture capitalist has in his mind. The first vital questions: What exactly will be sold and to whom? Other key market questions are:

- Why will the customer buy your product?
- Who are its ultimate users and what major influences on their purchasing habits are beyond your control?
- Who will be your competitors? Are they profitable now? Why do you think you can successfully compete with them?
- Is your market large and growing? Does it offer a multi-million dollar potential for your company?
- Are you or will you be in a recognized growth industry?

You should then ask and answer several questions about the other major aspects of the business you contemplate, questions about your team, your financial needs and the risks you are running. Such questions may include:

- What is the maximum amount of dollars and length of time that will be needed before your product is ready for market?
- What is the depth of your team's knowledge and extent of their reputations in the types of markets, technologies, and operations in which you will be active?
- What are your team's management skills in the three key areas of marketing, finance and operations?
- How many unproven marketing, technical and manufacturing approaches to you contemplate?

- What are the strengths, weaknesses and major risks of your venture?

If you are comfortable with your own answers in all of the areas discussed, you can probably justify developing a business plan.

In Summary

The risks in entrepreneurship are the entrepreneur, the management team, and any fundamental flaws in the venture idea. You must make a reasonable first evaluation of these risks. One should then be able to put together a business plan and avoid many of the early errors (for example, team inadequacies, underpricing, weak cash management) that so often cripple new ventures. You should also be able to improve your chances of securing financing and launching a successful venture.

Guidelines for Dealing with Venture Capitalists

The relationship between entrepreneur and venture capital investor is unique and it can be a very significant factor in determining the success of a business development. Often referred to as a marriage, the venture capitalist/entrepreneur association, as in any union, can achieve common purposes if the partners complement and support each other's capabilities, respect and understand different perspectives, and develop sensitivity to each other's actions and reactions. Successful rapport contributes to the "value-added" that differentiates business development from passive investment and helps achieve the substantial rewards envisioned from venture capital investment.

Experienced venture capitalists should be viewed as a resource that goes beyond the provision of investment capital. The extent to which the benefits of professional venture capitalist involvement are realized depends upon the quality and chemistry of the relationship between a business' operating management team and the venture capitalist.

Presentation

The heart of the presentation is a written business plan through which the venture capitalist evaluates the potential development of a business and the capabilities of a proposed management team. Venture capitalists are constantly exposed to innovative and exciting new products, but products do not make a business -- successful businesses create and develop successful products. The management team must demonstrate an understanding of the market and an ability to thoroughly think through and evaluate the actions in the business plan to attract the attention of venture capitalists.

The business plan must be a product of the principal managers, rather than a polished exposition of outside consultants, since it documents management's knowledge and expertise in the disciplines necessary for independent business development. Most business plans presented are far too optimistic, but those that are too conservative will not attract an investor's attention. It is thus important to present reasonable expectations that both the management and the venture capitalist can accept as achievable.

Perhaps the most important part of the business plan and its presentation is the clear identification of the existing and future market needs as well as the niche that will allow a new or smaller growing business to exist and successfully expand. Too often, entrepreneurs are enthusiastic about a marvelous product and they expect the potential investor to recognize the product's need without documentation as to why or how the customer will purchase the product.

If presentations are made with adequate homework, facts are presented to avoid unpleasant surprises, and a natural and realistic expectation is made; the proper chemistry may be developed with venture capitalists to bring about a remarkable amount of assistance even prior to any final decision.

Investments of Interest to Venture Capitalists

There is now sure way of divining whether a particular business would be of interest to one or more venture capitalists. The characteristics that venture capitalists typically look for and how preferences may vary from firm to firm are:

1. Potential of the business to achieve a significant scale in a few years.

2. Quality of the management group aiming to make this happen.

3. Probability that the business could, assuming it reaches the planned scale, be merged, acquired or sold to the public to provide ultimate liquidity for the venture capital firm.

Business Potential

Until an entrepreneur has focused on a specific opportunity, he or she cannot put together the most appropriate management group. So, although most venture capitalists put "management excellence" as their top priority, the potential for scale is really the first consideration. The attributes of a business that has the potential for scale include:

- A product or service with sustainable proprietary features.

- An "unfair" advantage in terms of technical know-how or lead time.

- A market niche or segment in which these features/advantages show a clear economic benefit; higher quality, lower cost or improved productivity.

- A market whose size is potentially large enough and growing fast enough so that a believable share represents a substantial sales revenue in a few years.

- Access to that market through existing channels of distribution to identifiable customers.

- High gross margins to allow for errors that inevitably occur in rapidly growing companies and (if technology-based) to provide for substantial R & D expenditures.

No one business opportunity is necessarily going to have all these attributes; opinions will differ on what represents a substantial revenue and in how few years the revenue rate should be reached (5, 7 or 10 years). This will depend on the venture capitalist, perception of the risk, rate of return objectives and the stage of development of the business being considered. In what industries and companies are these characteristics to be found?

Excellence of Management

Regardless of what caused the formation of a company, excellence of management is a priority consideration. In determining whether an investment is of interest, venture capitalists do not necessarily require a management team to be complete or contain all the functions. However, the nucleus present must have the qualities to attract the full team needed to build a successful company. These qualities include such things as experience, knowledge, perseverance, leadership, creativity and stamina.

Liquidity

Assuming the management team is sound and the business is attractive, the issue the venture capitalist then addresses is ultimate liquidity, i.e., is the business capable of being merged, acquired or sold to the public. The entrepreneur who is determined to remain independent as a private company can assume there will be no interest from venture capitalists. Assuming the entrepreneur can contemplate one of the exit routes and will seek private or public partners, the projected profits five years out multiplied by the appropriate price/earnings ratio must result in a valuation that could give the venture capitalist the gain sought on the capital to be employed.

Conclusion

To have an investment of interest, management must prove its excellence through the presentation of a business opportunity that can achieve profitability, scale and, ultimately, liquidity.

V. Who is Providing Venture Capital in Africa?

Although venture capital has always existed in the African traditional business environment, the more structured venture capital funds, and related management companies capable of mobilizing both domestic and foreign funds, are only now being created.

In May 1993 the Africa Venture Capital Association was launched. There are now 16 member venture capital firms from all the major regions in Africa. A list of the members is included in Appendix 1. If you have a sound business plan and a feasibility study for your project, and your business is located in one of the countries where a venture capital fund has already been established, a meeting with the fund's investment managers might to useful. They can best explain what their investment criteria are and may be able to suggest other sources of technical assistance which could help put your project on a sound footing. Remember, venture capital investors are not development agencies and they do not have the resources to complete your feasibility study.

There is a much older group of specialized development finance institutions (DFI) dating back to the time of independence in the 1960s. Many of these DFIs where heavily influenced by government development policy and were not free to make independent investment decisions. With the new emphasis on private sector development, these DFIs are either being restructured and put on a sound basis or they have gone out of business. Still, in some countries these DFIs may be sources of finance and technical assistance in evaluating horticultural projects. There is an extensive network of DFIs known as the African Association of Development Finance Institutions (AADFI) which is supported by the African Development Bank. A list of the AADFI members is included in Appendix 2.

Membership in AADFI includes some of the non-regional development finance institutions. These agencies are generally located in Europe and have historically provided technical assistance and long term finance for a variety of projects, including horticulture. These bi-lateral development agencies expect to earn a positive rate of return on their investments and will hold to the same general criteria as private venture capital funds. The difference usually is that these bi-lateral DFIs will accept a higher degree of political and economic uncertainty than the private venture capital funds. But their resources are limited. Governments need to create the right climate to attract the much more abundant supply of funds from private sector investors.

There are also multi-lateral and bi-lateral development agencies which can provide technical assistance and financing. The list starts with the World Bank which is active in programs that support macroeconomic adjustment, financial sector reform, strengthening of domestic financial institutions, provision of funds for on-lending, and increasing international capital flows through debt-reduction and co-financing programs. These programs are generally direct to governments and have helped significantly in creating the necessary enabling environments for private sector financing sector development to take place. See Appendix 3 for a list of these agencies.

The International Finance Corporation (IFC) was established in 1956 as an affiliate of the World Bank to further economic growth in its developing member countries by promoting productive private investment. Much of IFC assistance takes the form of long-term loans and risk capital, without government guarantees, to private enterprise that have difficulty raising funds from other sources on reasonable terms. In Africa, the IFC has two programs of particular interest to the entrepreneur. The Africa Project Development Facility (APDF) prepares project feasibility studies for a fee and assists the entrepreneur in arranging appropriate financing. The APDF works with projects which require $500,000 to $5 million in financing. The African Enterprise Fund (AEF) lends to African enterprises which meet their investment criteria in the range of $100,000 to $1 million. Contact their local offices in Abidjan, Nairobi or Harare for details.

The United Nations has two projects which are expected to assist in financial market development. One is a new program sponsored by the United Nations Development Programme (UNDP) in its recently established Division for the Private Sector in Development. The UNDP has as an objective to "create a predictable enabling environment in which entrepreneurs and investors will be encouraged to thrive and to move into the mainstream of development." Most of the assistance from the UNDP will be directed through governments, but there is a Small and Medium Enterprise Development emphasis placed on small scale credit programs and business incubators.

The African Development Bank (AfDB) provides loans and technical assistance to its African regional member countries. In 1990, the Private Sector Development Unit of the AfDB was established, similar to the IFC, to provide investment and expertise directly to private sector projects in the region.

Many countries have overseas investment promotion programs which provide various incentives, finance and risk insurance which can enhance the financial attractiveness of project. In the U.S., the Overseas Private Investment Corporation (OPIC) plays this role.

The United States Agency for International Development (USAID) has been active in many areas of financial sector development in Africa. In addition to sponsoring the Africa Venture Capital Project, USAID cooperated with OPIC in the creation of two venture capital funds in Africa. The Africa Growth Fund managed by Equator Bank has mobilized and invested $25 million committed to 10 projects in seven Sub-Saharan countries. Kenya Equities (KE) was the first country specific fund designed to bring domestic and foreign investors together. A great deal was learned from that experience resulting in a restructuring of KE last year and setting the ground for new growth.

We can conclude that there are both entrepreneurs and venture capital companies in Africa looking for ways to do business and make money, which is a dramatic change from even five years ago. Some banks, such as AMRO in Kenya, are increasing their lending activities to horticultural projects because they know and understand how to evaluate the risks and have a firm footing in the European buyer markets. More financial institutions willing to assess projects and take prudent financing risks are required.

VI. The Role for Governments and Development Agencies

Now we come to the role of governments and development agencies should play in supporting the development of venture capital, and the full range of financial institutions required to support private sector business growth in Africa.

The need in Africa for debt and equity financing for small and medium size enterprises (SMEs) has been well documented and is widely understood. Existing commercial banks have not been prepared to provide more than limited short term trade finance and occasional working capital. Earlier development finance banks were not adequately managed and generally made poor investment decisions. The result is insufficient financing for SMEs which are ready to grow.

Generally the larger scale industries have been either sate owned enterprises with subsidized access to credit from the government controlled commercial banking system or foreign owned companies with credit risk taken by non-African financial institutions. We are not considering the financing of the traditional cash crop operations which fall into this category. Rather, we are looking at the medium to small firm with dynamic entrepreneurs pushing a new idea, bursting with potential but lacking in financial capital and perhaps management know-how. These are the companies in search of new sources of financing. The promotion of microenterprises is a separate issue as they are not appropriate targets for venture capital financing.

Nurturing new techniques for the mobilization of venture capital is also a central issue which many development agencies have been focusing on. Management of those venture capital funds must be modeled on developed world standards. In addition to a high level of professional capacity, there must be complete transparency and discretion in managing investments. Many instruments which may be desirable from a developmental perspective, may not be attractive to the venture capital management. This will be the hard adjustment for government authorities to keep hands off the investment management.

The government's main role should be to provide appropriate tax incentives, support the establishment of sound organized markets for new companies, and ensure that the regulatory framework for pension funds, insurance companies, and other institutional investors does not unduly prevent them from investing in venture capital firms of recognized performance. Making equity investments requires long term risk taking. If the 5-10 year economic outlook contains too many unknowns, the venture capitalist will not invest. While not exhaustive, some preliminary observations based on our experience can be made which indicate the challenges which face governments in promoting venture capital financing in Sub-Sahara Africa.

1. Consistent and continuing highest level political support for private sector development is essential for creating a stable environment for long term venture investing. In countries where this government commitment does not exist, venture capital will be limited in its success.

2. It is important to establish good working relations between government officials involved in the approval and regulatory process and the investment community. The venture capital investment concept is new and usually requires extensive negotiations to obtain all required government authorizations prior to establishing operations, and these negotiations are best based on mutual understanding.

3. Entrepreneurs with experience and viable projects do exist in African countries. What they lack is experience in developing trade and business partnership links abroad, in addition to difficulties in accessing financing sources. Trade development organizations could provide important assistance in concluding representational or joint-venture agreements. Also, creation of local business groups across industry lines could be an important means for these entrepreneurs to share information and build a productive dialogue with the government for change.

4. Venture capital investing requires partnership with the local business community. There must be extensive local involvement in the investing and managing to build capacity and insure sustainability and replicability which development agencies and governments can promote.

5. A broad range of banking products to meet expansion and working capital needs, and to leverage the venture capital investment, is essential to long term success. Support for development of the financial services industry in most African countries must continue.

6. Stock market development, while not critical at the early stages of venture capital investment, will become important in providing the investor demand for initial public offerings. In the meantime, simple and even rudimentary methods of creating a secondary market in securities must be encouraged. This is as important for the venture capital industry as for savings formation.

7. Building venture capital investments will be a slow process. Venture capital is not a solution for the vast majority of entrepreneurs looking for funds. Only a few will have the skills and the business strategy to attract risk capital. Both the public and private financial sectors seem to understand and accept this limitation and are often willing to invest their own funds. Governments must understand the proper role of venture capital and not over inflate expectations.

What follows are some concluding thoughts on how governments can forge new partnerships with private sector finance, including venture capital.

Impetus for an Improved Enabling Environment

The introduction of venture capital funds can have an important developmental effect on the enabling environment which still needs to be improved in most African countries. Specifically, a fund's initial entry into a country, and subsequently, specific investment transactions, will help to identify the policies, regulations and practices that constitute obstacles to investments and other business activities in that country. For example:

- a small business lending program might lead to a review of collateral requirements and more modern lending approaches for SMEs generally;
- the venture capital fund's interest in privatizing, or privatized, companies could help to focus on asset evaluation and other policies; and
- the fund's interest in developing the capital markets in a given country may help the authorities there to focus on the need for appropriate disclosure regulations.

A recent shift in thinking has taken place as to the importance of private sector development to the overall growth cross Africa. Success of private enterprise is dependent on a stable, level, less protectionist playing field to stimulate investment, increase exports and promote further integration into the world economy. However, to the extent that inefficient or unfriendly regulatory environments and market-distorting policies still exist, they lower the attractiveness of the region for investors.

Supportive Climate for Business

A government attitude should prevail which relies on the private sector to generate economic growth while focusing government efforts to support the creation and maintenance of a positive business climate. A private sector oriented public policy can be reflected in an enlightened investment code, an active privatization program, a one stop location to interact with investors, an efficient process for issuing the necessary approvals, generally minimal bureaucracy and delays in decision making, and clear legislation and regulations that are stable in the sense of not being subject to frequent unpredictable changes.

A favorable business climate also requires policies and incentives necessary for the country to compete effectively for domestic and foreign investments, such as: protection against expropriation; the ability to transfer capital and profits; unrestricted access to domestically produced or imported raw materials and spare parts; a reasonable tariff structure and the absence of uncontrolled contraband; enforceable property and contractual rights; reasonable corporate and individual income tax rates, etc.

Legal and Regulatory Framework

Specific laws and policies in individual countries may act to discourage investors or particular investments. For example, in many countries investors cannot acquire title to land but only long term leases, since the government owns all or most of the land. While these leases can and often are routinely renewed, the process of issuing them can be poorly coordinated among issuing agencies and the resulting uncertainty can be disconcerting to potential investors. Enforcement of legal contracts and protection from corruption and unethical business practices is of prime importance. Smuggling and avoidance of regulations remain as key barriers to formal sector business development.

Infrastructure Problems

The rail transportation, roads, electrical generating and distribution system, water, sanitation and telecommunications is inadequate or badly deteriorated in many countries. Continued improvements is a key role for governments and donor agencies to build the infrastructure which attracts private sector investment.

Financial Sector

A formal financial sector comprising public and private, financial and non-financial institutions in sufficient numbers to provide diversity and competition, ably staffed and managed, is essential to an attractive business climate. Such a system should include a central bank to provide minimal supervision and regulation of financial institutions, commercial banks, and a basic money and capital market. The latter should include a basic stock exchange and related brokerage services, as well as a regulatory framework dealing with registration and disclosure.

Need for Technical Assistance and Training

In order to build bridges for investment capital flows and to increase the participation of indigenous Africans in the process, substantial technical assistance (TA) and training is required. Specifically, TA and training will be needed at three different levels:

1. Deal-Specific Assistance to Client Companies of the Funds

Venture capital financing, by definition, requires investee companies to prepare detailed business plans, to negotiate the terms of the proposed investment, and to accept a high degree of external investor management involvement in the entrepreneur's business.

Black-owned SME entrepreneurs frequently need assistance even with the preparation of loan applications for commercial banks. There is no question that these entrepreneurs need assistance and training to apply for long term and risk capital financing, which is even more difficult to assess than loans.

Research programs are also needed in order to provide information on industry, financial markets, pricing and other related data. This information is the bases for investment decision making and management. In developed economies, private sector firms develop and sell on demand such information.

2. Financial Management Training

The successful establishment of venture capital funds in Africa presumes a relatively sophisticated level of education, skills and experience for entrepreneurs and financial sector professionals who will administer the funds.

The fund's staff needs to have specialized training in evaluating business plans, evaluating business risks, finding co-investors, and structuring and negotiating investment terms. At the fund management level, actual experience with venture capital transactions and the management of venture capital funds is essential. There are few Africans fully qualified in these disciplines, although there is a nucleus of experienced financial professionals in each region to build on. TA will be required to develop these skills.

Broader training will be needed for entrepreneurs and employees of SMEs who are the prospective beneficiaries of an equity capital fund. Skills needed at this level may include: general organizational management; production and quality control; financial management; marketing and sales; and possibly importing and exporting.

3. General Business Education

To take fuller advantage of the business development potential in African countries, far more emphasis needs to be given to general business education and skills training. In most countries we have visited, courses offered at secondary and university level do not produce the skill level required by prospective entrepreneurs. In most countries, there are business associations that provide some short-term training, but such training is often under funded and is not on the scale needed to provide the requisite training required in the region.

Even where the requisite education and training is available, it is not always offering appropriate business management training and frequently is not producing graduates with such training in sufficient numbers to manage existing and would-be African businesses. Black Africans, in particular, frequently do not have access to higher level education.

We conclude by stating the obvious. The challenges are many and the obstacles are great, but the economic promise for Africa as we enter the 21st century is also abundant. What course will be taken is in the hands of the people, governments and private sector working together to find new solutions. Venture capital investing will be a partner in the development of the new Africa.

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APPENDIX 1

AFRICA VENTURE CAPITAL ASSOCIATION MEMBERS

AFRICA VENTURE CAPITAL ASSOCIATION

	NAME/ ORGANIZATION	CONTACT PERSON/ ORGANIZATION	COUNTRY Tel/Fax
A	Charter members- Corporations		
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2	Mr Yebca Amoa	Ghana Stock Exchange	Ghana
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Managing Director	P.O. Box 1849 Accra, Ghana	233-669913 Fax

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Honorary members

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President - The African Development Bank	
Mr. George Aithnard	Cote d'Ivoire
Director - The African Development Bank, Training Center	
Mr. Kofi Bucknor	Cote d'Ivoire
Treasurer - The African Development Bank (Resigned in March '94)	
Ms. Alice M. Dear	
U. S. Executive Director to the African Development Bank	Cote d'Ivoire
Mr. Baba Moussa	Ghana
President - W. African Development Bank	

APPENDIX 2

AFRICAN ASSOCIATION OF DEVELOPMENT FINANCE INSTITUTIONS

2. Special Members

- Fonds Africain de Garantie et de Coopération Economique (FAGACE) (Bénin)
- Fonds de Solidarité et d'Intervention pour le Développement de la Communauté des Etats de l'Afrique de l'Ouest (FOSIDEC) (Burkina Faso)
- PTA Bank (Burundi)
- Banque Africaine de Développement (BAD) (Côte d'Ivoire)
- Banque de Developpement des Etats de l'Afrique Centrale (Congo)
- Arab Bank for the Economic Develpopment of Africa (BADEA)(Sudan)
- Banque Ouest Africaine de Développement (BOAD) (Togo)
- Fonds de la Compensation et de Développement de la Communauté Economique des Etats de l'Afrique de l'Ouest (CEDEAO) (Togo)
- East African Development Bank (Uganda)
- Banque de Développement des Etats des Grands Lacs (Zaire)

3. Honorary Members

- International Bank for Reconstruction and Development (IBRD)(USA)
- Federal Business Development Bank(Canada)
- Commonwealth Development Corporation (United Kingdom)
- Caisse Française de Développement (France)
- Centre for Financial Assistance to African Countries (FINAFRICA) (Italy)
- Banco de Fomento Exterior (Portugal)
- Instituto de Credito Official (ICO) (Espagna)
- SIFIDA (Switzerland)
- World Assembly of Small and Medium Enterprises (India)

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APPENDIX 3

SOURCES OF TECHNICAL AND FINANCIAL ASSISTANCE

SOURCES OF TECHNICAL AND FINANCIAL ASSISTANCE IN AFRICA

Development Finance Institutions (DFIs)

CDC Commonwealth Development Corporation (United Kingdom)
DEG German Finance Company for Investments in Developing Countries
FINNFUND Finnish Fund for Industrial Development Cooperation, Ltd.
FMO Netherlands Development Finance Company
IFU Industrialization Fund for Developing Countries (Denmark)
PROPARCO Societe de Promotion et de Participation pour la Cooperation Economique

Bi-Lateral Aid Agencies

APSO Agency for Personnel Services Overseas (Ireland)
BESO British Executive Services Overseas
BITS Swedish Agency for International Technical and Economic Cooperation
CESO Canadian Executive Services Overseas
CFD Caisse Francaise de Developpement
IESC International Executive Services Corps (U.S.)
SwedeCorp Swedish International Enterprise Development Corporation
USAID United States Agency for International Development
OPIC Overseas Private Investment Corporation (U.S.)

Multi-Lateral Aid Agencies

AfDB African Development Bank
CDI Center for Development of Industry (European Community)
IBRD International Bank for Reconstruction and Development (World Bank)
IFC International Finance Corporation
AEF Africa Enterprise Fund
APDF Africa Project Development Facility
UNDP United Nations Development Programme
UNIDO United Nations Development Programme